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SUBJECT: Taiwan Economic Briefing for January 2005

[1](#)1. This cable summarizes selected recent economic events in Taiwan in January 2005:

- Taiwan-China cross-Strait charter flights
- Taiwan's banking sector performance
- Taiwan's 2005 central budget
- New Free Trade Zones
- Domestic investment slows
- TSMC Chairman on Taiwan's economic performance
- Taiwan's TSMC settles its IPR case with China's SMIC

#### Wheels-Up for Cross-Strait Charter Flights

[1](#)2. To much fanfare, the first Chinese planes to arrive in Taiwan in 56 years touched down at Taipei's Chiang-Kai Shek International Airport on January 29. A total of nine flights crossed the Taiwan Strait on the first day of the much-anticipated Lunar New Year charter flights for Taiwan businessmen in the Mainland. Seven flights from China to Taiwan carried 1,366 passengers. Two flights brought 239 passengers to the PRC. Air carriers report that tickets are selling well, particularly on the routes from Shanghai to Taiwan, some of which are fully booked with a waiting list. The Guangzhou routes are less popular. For its first Guangzhou to Taipei flight, TransAsia reports that 80% of seats have been booked. Because the flights are exclusively for Taiwan businessmen and their families, and New Year's is the traditional time to return home, traffic headed to the PRC before the holiday is naturally much lighter. TransAsia's Taipei to Guangzhou flight is only 20% booked. The first day of flights was marked with ceremonies and fanfare at the airports. However, high-level Taiwan government officials did not attend. Observers from across the political spectrum have hailed the charter flights as an important step in cross-Strait relations, but some Taiwan government officials have cautioned that more negotiation is needed before the charter flights can be expanded to more regular air service. The flights will continue through February 20.

#### Improved Banking Performance

[1](#)3. Bureau of Monetary Affairs statistics for 2004 released in January show that Taiwan has reduced the financial sector's non-performing loans (NPL - principal or interest three months or more overdue) by a third to NT\$590.7 billion (US\$18.4 billion). The average NPL ratio dropped from 6.06% to 3.8% and bad debt reserves increased from 34.7% of NPLs to 41.4%.

[1](#)4. Over recent years, NPL reduction efforts such as writing off bad debt and selling problem assets have been a major factor in the financial sector's low combined pre-tax profits. Taiwan banks posted a combined pre-tax loss of NT\$104.6 billion in 2002, and a small profit of NT\$57.6 billion in 2003. Pre-tax profits nearly tripled in 2004 to NT\$159 billion. Taiwan banks combined rate of return against assets (ROA) rose from minus 0.34% in 2002 to positive 0.15% in 2003 and positive 0.63% in 2004. The rate of return against net worth (ROE) also increased from minus 6.0% in 2002 to positive 2.8% in 2003 and 10.3% in 2004. Taiwan banks' average ROA of 0.63% and ROE of 10.3% still remains well below international average of one percent ROA and 15-20 percent ROE. Taiwan is promoting consolidation to further improve profitability.

## Taiwan's 2005 Central Budget

15. Taiwan's Legislative Yuan (LY) passed the 2005 central budget just before midnight of January 20, 2005, well past the legal deadline of December 31 of 2004. The approved budget slashed the Chen Administration 2005 funding request by NT\$71.6 billion (US\$2.2 billion) to NT\$1,402.7 billion (US\$43.8 billion) and cut expenditure by NT\$27.2 billion to NT\$1,625.6 billion (US\$50.8 billion). Under the passed budget Taiwan's 2005 budget deficit will increase to NT\$277.3 billion (US\$8.7 billion) which is 10.3% less than the deficit of NT\$280.8 billion in 2004. The 2005 fiscal deficit, which includes the budget deficit plus debt repayment, will reach NT\$336.1 billion. The deficit will be financed by NT\$255 billion in bonds and NT\$81.1 billion coming from past government savings. The central government's outstanding debt should reach NT\$3,668 billion or 35.7% of GNP by the end of 2005, higher than the 21% in South Korea but much lower than the 113.1% in Singapore or Japan's whopping 169%.

16. The LY-approved budget cut by 20% funding for Ministry of Economic Affairs (MOEA) efforts to promote private research and development activities. The cut will prevent research and development spending from reaching the announced target of three percent of GDP by 2008. Other cuts include total elimination of revenues from sales of equity shares in state-owned enterprises, removing the legal basis for the privatization programs being conducted by the MOEA and other agencies. The LY also passed a resolution to block increases in national health insurance premiums without express consent of the LY.

## Free Trade Ports Struggle to Find Tenants

17. Taiwan's government has approved three FTZs, including one in Keelung which began operating in October 2004, another in Kaohsiung which started operating in January 2005, and a third in Taichung scheduled to start operating in October 2005 (reported septel). As of mid-January, officials of Kaohsiung and Keelung Harbors reported lower-than-expected interest in the new free trade zones. Kaohsiung Harbor officials report that 11 firms have signed letters of intent to participate in the FTZs, but media reports indicate that only two firms have actually submitted applications to operate in the zone. Keelung, which started accepting applications earlier than Kaohsiung, has only received one such application. Factors discouraging investors include a requirement that 5% of employees in the FTZs must be Taiwan aboriginals, and the fact that many of the tax benefits offered in the FTZs are similar to those offered in Taiwan's science parks and other special economic zones.

18. In addition to the above-mentioned three FTZs, another three are under reviewed by ministerial agencies, including one near CKS Airport, one to transform existing export processing zones into an FTZ, and one to be located at Taipei Harbor. According to the Council for Economic Planning and Development (CEPD), some 50 business firms have expressed interest to move into the FTZ near CKS Airport. Local governments and business conglomerates have expressed interest in construction of five others FTZs, including one in Kaohsiung City, two in Tainan, one at Mailiao Industrial Port of Yunlin, and one at Chang Bing Industrial Park of Changhwa.

## Rate of Investment Slows Down

19. Taiwan's domestic investment, slowed from 20% growth in Q2 to 10% growth in Q4 of 2004. Recent approval of NT\$100 billion for ten major public construction projects will contribute to a public investment increase of 3.1% in 2005. Projects such as the fourth nuclear power plant, Ta Tan natural gas power plant, and the sixth north-south power transmission line will cause SOEs' 2005 investment to grow 9.4%, compared to a decline of 12% in 2004. However, according to the Chunghua Institution for Economic Research the private sector will see a steady decline in investment growth in 2005, down from 10% in Q1 to seven percent in Q3. Factors behind the decline in private investment growth include higher oil prices and higher interest rates.

## When Morris Chang Speaks.

10. An Economic forum on Taiwan's prospects in 2005 (conducted in Taipei on January 31 in English) featured as speakers Taiwan Semiconductor Manufacturing Corporation (TSMC) Chairman, Minister of Economic Affairs Ho Mei-yueh, and Financial Supervisory Commission Chairman Kong Jaw-sheng. The press turned out in force for the event. The

government speakers lauded Taiwan's macroeconomic performance in 2004 and predicted solid growth in 2005. Minister Ho emphasized the sharp growth in private investment in 2004 (in spite of the quarter-to-quarter decline in growth rates), predicting that rapid growth would continue in the coming year. Chairman Kong highlighted the improved financial condition of banks in 2004 and confidently predicted development of a regional financial services industry in Taiwan in the coming years. Morris Chang spoke about Taiwan's competitiveness, citing Michael Porter's study done for the World Economic Forum that ranked Taiwan as the world's fourth most competitive economy. Chang was very complimentary about Taiwan's success in developing a wide variety of international leading industries, emphasizing that real GDP growth was good, noting that in terms of purchasing power parity, Taiwan's real growth is in the same class as OECD countries, and that technology leads the way for Taiwan's future growth. The press waited with baited breath for Chang's presentation, which came last of the three. In fact, they dogged his every move. When Chang left the room briefly during Kong's presentation, the entire press crew (including photographers) caused quite a stir when they decamped to see what he was doing. Chang stuck it out to the very end of the discussion group following the seminar presentations while the government representatives left immediately after their presentations: the press crew hanging on his every word, recording his every move.

TSMC and SMIC Settle Lawsuit

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[11](#). Taiwan Semiconductor Manufacturing Corporation (TSMC) announced an out-of-court settlement with the PRC's Semiconductor Manufacturing International Corporation (SMIC) of its U.S. lawsuits alleging violations of patents and theft of trade secrets (reported septel). SMIC agreed to pay TSMC US\$175 million over six years - US\$30 million each of the first five years and US\$25 million the sixth year. TSMC Chairman Morris Chang told media "the payment is

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acceptable despite not being satisfactory." The agreement also includes provisions for the two firms to license each other's patent portfolios through 2010. The price of TSMC stock on the Taiwan Stock Exchange rose 4% the day after the announcement.

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